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IN THE

Supreme Court of the United States

OCTOBER TERM, 1935

No. 379.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

SAN JOAQUIN FRUIT & INVESTMENT COMPANY, *Respondent.*

On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

BRIEF FOR THE RESPONDENT.

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On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

BRIEF FOR THE RESPONDENT.

OPINIONS BELOW.

The case was before the Board of Tax Appeals (16 B. T. A. 1290) when the merits were not considered but certain preliminary questions were decided. The Commissioner appealed to the Circuit Court of Appeals, Ninth Circuit, *Burnet* v. *San Joaquin Fruit & Investment Co.*, 52 F. (2d) 123, where the decision of the Board was affirmed in part and reversed in part. Thereafter a hearing on the merits was had before the Board of Tax Appeals, and the opinion

of the Board (R. 253-279) is reported in 28 B. T. A. 395; and on the taxpayer's appeal to the Circuit Court of Appeals, Ninth Circuit, the decision of the Board was reversed, *San Joaquin Fruit & Investment Co.* v. *Commissioner* (R. 338-344), reported in 77 F. (2d) 723.

JURISDICTION.

The judgment of the Circuit Court of Appeals was entered May 20, 1935 (R. 344). Petition for certiorari was filed on August 19, 1935, and was granted on October 14, 1935. The jurisdiction of this Court comes from Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED.

1. In 1906, respondent became lessee-optionee under a lease of 1,000 acres of bare land for a term of ten years, with option to purchase exercisable at the end of the term in 1916. Respondent entered into possession in 1906, promptly succeeded in developing an ample supply of underground water for irrigation, and before March 1, 1913, had developed the whole of the 1,000 acres into orange and walnut orchard. The value at March 1, 1913, was many times the option price, and it was then certain that the option would be (and it was) punctually exercised in 1916. For the purpose of determining gains on sales of the orchard after 1916 by respondent, was there an acquisition of "property" before March 1, 1913, so that the fair market value as of that date may be used as respondent's basis?

2. Alternatively, if a negative answer should be given to the foregoing, then was there a conversion of capital assets into a new form with essentially different characteristics when the extremely valuable option was converted into a fee simple in 1916, so that the fair market value of the fee simple when acquired on that date may be used as the basis of determining gains on resales at later dates?

STATUTES INVOLVED.

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1060:

Basis for determining gain or loss.

Sec. 202. (a) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—

(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and

(2) In the case of property acquired on or after that date, the cost thereof; * * *

* * * * * * * * *

Revenue Act of 1921, c. 136, 42 Stat. 227, 229:

Basis for determining gain or loss.

Sec. 202. (a) That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property, real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property; * * *

* * * * * * * * *

(b) The basis for ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, shall be the same as that provided by subdivision (a); but—

(1) If its fair market price or value as of March 1, 1913, is in excess of such basis, the gain to be included in the gross income shall be the excess of the amount realized therefor over such fair market price or value;

* * * * * * * * *

Revenue Act of 1924, c. 234, 43 Stat. 253, 258:

Basis for determining gain or loss, depletion, and depreciation.

Sec. 204. (a) The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; * * *

* * * * * * * * * *

(b) The basis for determining the gain or loss from the sale or other disposition of property acquired before March 1, 1913, shall be (A) the cost of such property * * * or (B) the fair market value of such property as of March 1, 1913, whichever is greater. * * *

* * * * * * * * * *

STATEMENT.

In 1906, the 1000 acres in question were bare and unirrigated land, overgrown with sagebrush and cactus (R. 340), and was part of a holding of approximately 100,000 acres owned by Irvine Company, a corporation, all of the stock of which, excepting some qualifying shares, was throughout 1906 (and continuously thereafter until 1920) owned by James Irvine, who dominated and controlled said corporation (R. 261).

In 1906, Sherman Stevens and C. E. Utt, experienced agriculturalists and orchardists, negotiated with James Irvine for the purchase of said 1000 acres from the latter, for the purpose of developing it into orchard (R. 297). The land was carefully selected out of said holding of 100,000 acres, and was well adapted for development into a citrus grove, and needed only the development of sufficient water for irrigation (R. 316). There was no known water supply within or upon said 1000 acres, but there was a known, partially developed artesian supply of unknown quantity about two miles distant upon the ten-acre tract hereinafter referred to (R. 314, 340). For the development of a citrus orchard, one flowing inch (a stream of twelve gallons a minute) of water is sufficient for four acres of orchard, or 250 flowing inches for 1000 acres (R. 311, 315). All other factors of success were present, and the development

of sufficient water would make certain the successful commercial improvement of said 1000 acres into orchard (R. 299).

Sherman Stevens and C. E. Utt at that time had cash capital of approximately $30,000.00 each, which they desired to use in capital expenditures in water development and in improvement of the said 1000 acres, without application of any part thereof upon purchase price of the land. James Irvine desired to have that amount of cash capital increased through a pro rata contribution by himself, in order to be certain of the improvement of the 1000 acres of land into orchard if sufficient water should be developed therefor (R. 299, 300).

Accordingly, the negotiations resulted in: (1) the organization on October 5, 1906, of a California corporation named San Joaquin Fruit Company, with a capital stock of $100,000.00, divided into 1000 shares of the par value of $100.00 each, of which 810 shares were issued to James Irvine, Sherman Stevens and C. E. Utt, for $81,000.00 cash paid in, at the rate of $27,000.00 each; and (2) thereupon a lease of said 1000 acres to San Joaquin Fruit Company for a term of ten years beginning December 1, 1906, and ending November 30, 1916, was caused by James Irvine to be made by Irvine Company (R. 261).

Thereunder, San Joaquin Fruit Company was required to set out and plant the whole of said 1000 acres to orchard, within four years from October, 1906; and to enter upon a ten-acre tract of water-bearing land about two miles distant from said 1000 acres, and sink wells for water and develop water to a volume of 250 flowing inches, and conduct it by pipe line to said 1000 acres, and to irrigate the orchard thereon; and to raise crops of grain, beans, peanuts or other products on such portions of the land as could be cultivated without material injury to the trees. And, as a part of said lease and of the consideration thereof, Irvine Company granted to San Joaquin Fruit Company an irrevocable option, exercisable on November 30, 1916, to buy

said 1000 acres at a price of $200.00 an acre, or a total of $200,000.00 for the whole (R. 261-262).

By the summer of 1907, several wells had been drilled by the lessee-optionee, San Joaquin Fruit Company, to depths of 300 to 400 feet on said ten-acre tract, a pipe line therefrom to said 1000 acres had been installed, and water was running to the highest elevation of said 1000 acres, and within two years from October, 1906, the full 250 flowing inches of water in a continuous and certain supply had been fully developed and the whole of said 1000 acres placed under full and adequate irrigation (R. 314-315) and the success of the whole project, and the exercise of said option, had become certain and were known and intended by all of the parties to be certain (R. 317, 310). The soil is a very deep, rich, alluvial soil, and said 1000 acres rank, and on March 1, 1913, ranked, among the finest in California for successful commercial production of oranges, lemons and walnuts. By March 1, 1913, said 1000 acres were fully improved with 390 acres of orange trees (140 acres 6-year old, and 250 acres 4-year old), and 600 acres of walnut trees (500 acres 6-year old, and 100 acres 4-year old) (R. 262), thereby greatly enhancing the value of the property (R. 340).

Within four years after October, 1906, San Joaquin Fruit Company had made a capital investment of $150,000.00 to $170,000.00 in developing and improving said 1000 acres, with an adequate and complete water system, wells, pumps, pipe line, irrigating system, trees, buildings, equipment, and the like (R. 340). Throughout the period of ten years ending November 30 1916, Sherman Stevens and C. E. Utt gave the whole of their personal time and labor to the project (R. 317), Stevens and Utt each drawing only $100.00 a month cash, and Irvine nothing (R. 317).

On March 1, 1913, the value of the land was $1,635,000.00, and the value of the option was $1,360,000.00; on November 30, 1916, the value of the land was $2,150,000.00, and the value of the option was $1,950,000.00 (R. 340).

The growth of value by March 1, 1913, was due primarily to (1) the full development of an adequate supply of water for irrigation, and (2) the proving and developing of said 1000 acres as successful citrus and nut land, and (3) the provision of adequate financing of the project, and (4) the experience, ability, energy and creative work of Sherman Stevens and C. E. Utt (R. 315-317).

Said option was punctually and fully exercised on November 30, 1916, and the purchase price of $200,000.00 was paid and legal title to the land was transferred to the San Joaquin Fruit Company (R. 318).

In 1922, the San Joaquin Fruit Company was reorganized as the San Joaquin Fruit and Investment Company, the respondent, and all of the property was transferred to it. The basis of respondent is the same as that of San Joaquin Fruit Company (R. 262-264; 273-274).

During the years 1920 to 1928, respondent sold various tracts of the property. In considering respondent's tax liability for these years, the Commissioner determined that the property was acquired by the San Joaquin Fruit Company on November 30, 1916, when the option was exercised, and that the cost was the $200,000.00 paid at that time for the land, plus the amounts paid for improvements under the lease agreement, and that this cost figure was the basis for ascertaining gain or loss (R. 338). The Commissioner's cost figure was not disputed (R. 275).

The Board of Tax Appeals approved the Commissioner's determination. The Circuit Court of Appeals reversed the decision of the Board, holding that the basis for determining gain or loss was the March 1, 1913, value of the property.

SUMMARY OF THE ARGUMENT.

The lessee-optionee acquired a property in the land, an interest real, before March 1, 1913, and therefore the fair market value on that date is the proper basis in determining gains on sales of the lands thereafter. The lan-

guage of the Revenue Acts is "property acquired before March 1, 1913," and the persistent error of the Commissioner has been in his attempt to read "property" as though it read "fee simple," or "legal title." The word "property" is not to be given such a narrow or technical meaning as is sought by the Commissioner. The cases relied upon by him are merely cases where an option was never exercised, or where, until exercised, the optionee was no more than a bare optionee out of possession.

The option at bar is far more than a bare option. (1) It was contained in a lease, (2) the lessee-optionee was in full, lawful and beneficial possession, (3) the lessee-optionee had expended $150,000.00 to $170,000.00 in developments and improvements by the close of 1910, or long before March 1, 1913, (4) by developing ample and continuous water, the lessee-optionee had transformed 1000 acres of desert into 1000 acres of fine citrus and nut groves, (5) long before March 1, 1913, it was certain that the lessee-optionee would exercise the option, (6) the lessee-optionee did exercise it, punctually and fully, on the day, and (7) on March 1, 1913, the option was worth well over a million dollars, and was steadily increasing in value.

The distinctions of fact just stated are distinctions of high importance, and establish the acquisition of a property in the land before March 1, 1913, for the following reasons:

First, the option was connected with a lease, thus making the option irrevocable, and indivisible from the lease, and giving the option the character of an interest real.

Next, the optionee went into possession at the time the option was given and that possession was continuous from 1906 through 1913 and beyond, and by three or four years before 1913, the optionee had made great improvements of the land, expending from $150,000.00 to $170,000.00 in developing and improving the bare land into an orchard. The facts of possession and improvements created a property

interest in the land. The essence of an ownership is beneficial possession and in the present case this possession has been continuous ever since 1906. It may be perfectly true that a bare optionee, not in possession, does not "acquire" a property until he exercises the option; but in the case of an optionee who is put in beneficial possession when the option is given, "acquisition" occurs when possession commences, and thereafter when the option is exercised the optionee merely announces that he has chosen not to surrender something that he had "acquired" theretofore. Being in rightful possession, and not subject to ouster even by the paper title, the optionee in possession has a substantial title, and then when he exercises a choice not to give up possession a "perfect" title ripens.

Next, the reasoning of the Circuit Court of Appeals is perfectly sound with respect to the modified form of the doctrine of "relation back" applied by it, and this is particularly true in the present context, *i. e.*, when the relation back goes no further than the time when continuous beneficial possession and use commenced. An acquisition of property is not related back upon the facts at bar; all that is related back is the optionee's decision not to give up the land.

Next, by March 1, 1913, the optionee had become the economic owner, the practical owner, of the land. Years before 1913, an ample supply of underground water had been developed and the 1000 acres of sagebrush and cactus had been developed into an orchard and walnut grove, which, on March 1, 1913, had a value of $1,635,000.00, and for which the optionee would have to pay only $200,000.00 when the time for exercise of the option arrived. On March 1, 1913, it was certain that the option would be exercised. Upon such facts the law is clear that the optionee in possession must be deemed to be the practical owner, or economic owner, of the property in the land. This is emphasized by the fact that on March 1, 1913, *someone* owned the property; it could not be the optionor, because his title was *cum*

onere, burdened by the obligation to sell at $200,000.00; the difference of nearly one and a half million dollars was necessarily owned by the optionee, and that was so nearly the whole value that it must be self-evident that the optionee in possession was the economic owner of the property.

If none of the foregoing propositions be true, then it must follow, in the alternative, that on November 30, 1916 (when the option was exercised) the capital of the optionee was converted from one form into another form having essentially different characteristics, and therefore the value on that date would be the basis for determining gains on sales of lands thereafter.

ARGUMENT.

I.

There Was an Acquisition of Property in the Land, an Interest Real, Before March 1, 1913, so that the Fair Market Value as of that Date is the Proper Basis in Determining Gains on Sales of the Land.

The language of the Revenue Acts is "property acquired before March 1, 1913." The term used is not "fee simple," nor is it "legal title"; the word is "property." There "is nothing to suggest that the word 'property' is used in any restricted sense," *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364, 369, and it "should not be given a narrow or technical meaning," *Commissioner* v. *Stephens-Adamson Mfg. Co.*, 51 F. (2d) 681, 682. The "term 'property,' as applied to lands, comprehends every species of title, inchoate or complete, and embraces rights which lie in contract, executory as well as executed," *Bryan* v. *Kennett*, 113 U. S. 179, 192; *Falk v. Commissioner*, 64 F. (2d) 171, 172. In the term, "all titles are embraced, legal or equitable, perfect or imperfect," *Bryan* v. *Kennett, supra* (113 U. S., at 192).

In his petition to this Court, and in his brief in the Circuit Court of Appeals, the Commissioner has persistently used the term "property" as a synonym of "fee simple"

or "legal title" or "complete and perfect title." The Commissioner's argument has been that, until exercise of option, an optionee of land is neither legal nor equitable owner of an interest in the "property." Of the cases heretofore cited by the Commissioner, some were cases of a bare optionee out of possession who never exercised his option,

Richardson v. *Hardwick*, 106 U. S. 252,
Phenix Ins. Co. v. *Kerr*, 129 Fed. 723;

in another there were merely some obiter remarks arguendo,

Todd v. *Citizens' Gas Co.*, 46 F. (2d) 855, 866;

in two of the cases there was merely a bare optionee of stock rights,

Commissioner v. *Cummings*, 77 F. (2d) 670,
Chisholm v. *Commissioner*, 79 F. (2d) 14;

and finally, in

Lucas v. *North Texas Lumber Co.*, 281 U. S. 11,

we find merely a bare optionee out of possession, without more.

In the case at bar, the situation differs greatly, in many ways.

Respondent did not have a mere option, or bare option. (1) Respondent's option was contained in a lease, (2) respondent was in full, lawful and beneficial possession, (3) it had expended $150,000.00 to $170,000.00 in developments and improvements by the close of 1910, or long before March 1, 1913, (4) by developing ample and continuous water, it had transformed 1000 acres of desert into 1000 acres of fine citrus and nut groves, (5) long before March 1, 1913, it was certain that it would exercise the option, (6) it did exercise it, punctually and fully, on the day,

(7) on March 1, 1913, respondent's option was worth well over a million dollars, and was steadily increasing in value.

We therefore turn to a presentation of the effect of those differences, in establishing in respondent a *property* in the land on and before March 1, 1913:

(a) *Respondent had an interest in land, by virtue of the option covenant being a covenant real, contained in a lease, under which respondent was in full, lawful and beneficial possession at March 1, 1913.*

The California case of *Ludy* v. *Zumwalt*, 85 Cal. App. 119, cited in the opinion of the Board (R. 268), is not in point; moreover, it was fully explained and distinguished by the Supreme Court of California in the case of

> *Chapman* v. *Great Western Gypsum Co.*, 216 Cal. 420, 14 Pac. (2d) 758, 85 A. L. R. 917,

which latter case demonstrates that by the law of California, from the earliest day, an option covenant *contained in a lease* is a covenant real, *i. e., real property.* The Court expressly distinguishes the cases of options "*unconnected* with an interest in property, such as a *lease*," and fully and expressly distinguishes *Ludy* v. *Zumwalt, supra,* saying that "whatever was said in [*Ludy* v. *Zumwalt*] as to the nature of an option unconnected with a lease or other interest in land can have no application to a case where the option is so connected."

The lease and option are indivisible; an option contained in a lease is irrevocable and is not severable. As said by the Supreme Court of California in *Gordon* v. *Dufresne*, 205 Cal. 512:

> "The question of the divisibility of lease and option agreements of the type here presented has been before this court many times, and it has been many times decided that such agreements are not severable, but that, on the contrary, the lease and option form one document, the provisions of which are interdependent,

> and the covenant to pay rent or do other acts supports the option as well as the right to occupy the premises. Prichard v. Kimball, 190 Cal. 757, 214 P. 863; Cates v. McNeil, 169 Cal. 697, 147 P. 944; Hall v. Center, 40 Cal. 63; De Rutte v. Muldrow, 16 Cal. 505; 35 Corpus Juris, pp. 1038, 1039."

Our entry on the land in 1906 was not merely as lessee; it was an entry as lessee-optionee, and the possession taken by respondent in that year has been continuous, rightful and undisturbed ever since.

(b) *Respondent had an interest in land, by virtue of being an optionee in possession, who had expended a large sum of money in development and improvement of the land.*

The case of *Crowell* v. *Ewing,* 4 Cal. App. 358, 88 Pac. 285, was a case of an optionee in *possession* of mining property, who had made $20,000.00 *improvements,* and it was held that possession and improvements, coupled with the option, gave him "an actual interest" in the land.

At bar, respondent had been in possession continuously from 1906 through 1913 and beyond, and within two years after 1906 respondent developed the required amount of water for irrigation purposes and by the close of 1910 expended from $150,000.00 to $170,000.00 in developing and improving the tract (R. 262).

The case of *Crowell* v. *Ewing, supra,* finds strong support in *Bryan* v. *Kennett, supra* (113 U. S. 179), where "taking possession of the land and improving it" (113 U. S. 191) was held to create a property in the land; this Court said that it was not necessary to "define the precise nature and extent of the interest acquired by Austin in this land," it being sufficient that he had a property in the land. It is unnecessary to the ownership of an interest in real property that the owner of the interest be able to give a name to the interest, or assign it to any particular pigeon-

hole, but the *substance* is looked to, *Estate of Pitts*, 218 Cal. 184, 191.

> "Possession has always been a means of acquiring title to property. It was the earliest mode recognized by mankind of the appropriation of anything tangible by one person to his own use, to the exclusion of others, and legislators and publicists have always acknowledged its efficacy in confirming or creating title."
>
> *Campbell* v. *Holt*, 115 U. S. 620, 623.

The very substance of property in land is *possession;* "title" is merely a means to possession.

> " 'Title' is defined as the means whereby the owner of lands hath the just possession of his property."
>
> 2 *Bl. Comm.* 195;
>
> *Arrington* v. *Liscom*, 34 Cal. 365, at 385.

In 1906, respondent acquired a rightful possession, good against the world, even against the optionor, and it was entirely a matter of its own *choice* (option) whether it would ever give up possession. It was not a matter of choosing to *acquire* possession; it was, conversely, a matter of choosing whether respondent would give it up. Respondent had "a substantial title," and when it chose not to give up possession, a "perfect" title ripened.

> "The party who has acquired an absolute right of possession, which will not only shield him in his possession against the attacks of all the world, but, when ousted, will restore him to, and protect him in, his just possession, even against the party having the written title, would seem to have a substantial title."
>
> *Arrington* v. *Liscom, supra* (34 Cal., at 385).

> "Possession has all but swallowed up ownership; and the rights of a possessor, or one entitled to possess, have all but monopolized the very name of property."
>
> *Webbs' Pollock on Torts*, 417;
>
> 1 *Jones' Bl. Comm.* 973-978, note, "Nature of Possession," by Pollock.

The Civil Code of California, section 654, defines the ownership of a thing as "the right of one or more persons to *possess and use* it to the exclusion of others." That literally describes the right of respondent, from 1906 continuously onward. Clearly, respondent had a property in the land on March 1, 1913.

(c) *San Joaquin Fruit Co. owned the land at March 1, 1913, under the doctrine of relation back.*

The earliest tax year involved in the cases at bar is the tax year 1920. Long before then, the ownership of the San Joaquin Fruit Co. had been *related back* to the year 1906, so that (with respect to all tax years here involved) San Joaquin Fruit Co. was the owner of the 1000 acres as at March 1, 1913. In considering a land optionee's interest in California, two situations plainly distinguish: (1) Non-exercise of the option, the result of which is that the optionee is deemed never to have had any interest in the land; (2) *Exercise* of the option, the result of which is that *an equitable interest in the land* is related back to the day the option was given:

Smith v. *Bangham,* 156 Cal. 359, 365 (104 Pac. 689, 28 L. R. A. N. S. 522);
Crowley v. *Byrne,* 71 Wash. 444, 129 Pac. 113;
Horgan v. *Russell,* 24 N. D. 490, 140 N. W. 99, 43 L. R. A. N. S. 1150;
People's Street Ry. Co. v. *Spencer,* 156 Pa. 85, 27 Atl. 113, 36 Am. St. Rep. 22;
Kerr v. *Day,* 14 Pa. 112, 53 Am. Dec. 526.

When a lessee exercises an option to purchase, he is to be considered as the owner *ab initio.* (*People's Street Ry. Co.* v. *Spencer, supra,* at 27 Atl. 114, col. 2.)

Only a superior, intervening *equity* prevents the relation back, *e. g.,* a purchase-money lien:

Shay v. *McNamara,* 54 Cal. 169;
Hawkins v. *Harlan,* 68 Cal. 236, 9 Pac. 108;
Ludy v. *Zumwalt,* 85 Cal. App. 119, 259 Pac. 52.

That is, when a superior, intervening equity exists, the doctrine of relation back is not applied, and the optionee is deemed not to have had an interest in the land until the day of acceptance. In the case at bar, however, the option was exercised in 1916, which was years *before* the incidence of the tax for the earliest tax year, 1920. Plainly, therefore, in determining taxes for 1920 and later years, respondent is deemed to have had at least an equitable interest in the land from 1906 onward. The incidence of the tax having been *after* the exercise of option, the United States has no superior intervening right.

The Circuit Court of Appeals took the following ground in its opinion (R. 343-344):

> "It is clear that so far as the rights of the seller and purchaser are concerned the contract resulting from the exercise of the option does relate back to the giving of the option. It is because of the binding offer from the optioner that the optionee is entitled to purchase the property at a fixed price at the time the option is exercised. The two contracts, the giving of the option and the contract of sale resulting from its exercise, are in effect parts of a single transaction differing from a completed sale in that the optionee is entitled to refrain from entering into the contemplated agreement of sale if he so desires. From the standpoint of the income tax laws the rights of the optionee, upon the exercise of the option, should be related back to the date the option was given and the resulting contract treated as having been made on that date. We conclude then that the optionee and lessee 'acquired' the land within the meaning of the income tax laws as of the time the option was given and that the taxable gain resulting from subsequent sales of a portion of the land should be determined by deducting from the selling price the value as of March 1, 1913 of the land sold."

Great strength is added to the foregoing reasoning when it is kept in mind that the Court was speaking to a context wherein *possession and use* were given to the optionee in 1906 when the irrevocable option was given. In considering

the doctrine of "relation back," we need not inquire whether the doctrine applies in the case of exercise of an option by an optionee *out of possession.* We have here continuous possession, use, and capital development and improvement continuously from the time that the option was given. Granting that in many situations the application of the doctrine of relation back is the application of a fiction, there is nothing fictitious about continuous possession, use, development and improvement. An *acquisition* of property is not related back upon the facts at bar; all that is related back is the optionee's decision not to *give up* the land.

(d) *On March 1, 1913, San Joaquin Fruit Co. was the economic owner, the practical owner, of the land.*

Full development of 250 inches, and more, of water was reached in about two years from October, 1906 (R. 314-315). By March 1, 1913, the thousand acres were fully improved with 390 acres of four and six year old orange trees, and 600 acres of walnut trees of similar age. On March 1, 1913, the developed and improved grove had a value of $1,635,000.00, and continued to increase in value until the option was exercised on November 30, 1916, when the value was $2,150,000.00 (R. 340). The option price was only $200,000.00. On March 1, 1913, it was certain that the option would be exercised (R. 310-311; 316-317).

The doctrine of "practical ownership" was applied by the Supreme Court of California in a case not nearly as strong as ours upon the facts. In the case of *Laffan* v. *Naglee,* 9 Cal. 663 (*662), a lease of a lot in San Francisco, for a term of eight years, with an option to buy, was made early in the year 1847. Then came the gold discovery of 1848, followed by the world famous "gold rush" of 1849, with consequent great increase in value of the lot, so great as to make exercise of the purchase-option a certainty; and under such circumstances, the Supreme Court of California

treated the lessee-optionee as the *practical owner* of the lot. As said by the Court, the circumstances were such that, in the nature of things, a sale would be *compelled* at a very low price, rendering the option so valuable that it was impossible to disregard it. (See 9 Cal. at *676.) In other words, the circumstances were such that it could be predicted with substantial certainty that the option would be exercised.

It was held in the Third Circuit, in

Commissioner v. *Pittsburgh Union Stock Yards Co.*, 46 F. (2d) 646,

that when in fact a valuable option existing on March 1, 1913, was exercised thereafter, and there was testimony that "on March 1, 1913, there was absolutely no doubt" that the option would be exercised, it would be treated as though it were exercised on March 1, 1913. That case has since been acted upon by the Government as authority for the doctrine of "prediction with substantial certainty," as will appear from *379 Madison Ave., Inc.* v. *Commissioner*, 60 F. (2d) 68, 70, col. 1. In the case at bar, at March 1, 1913, it certainly could have been, and was, predicted with certainty that the option would be exercised when the day for exercise arrived.

It was held in the Sixth Circuit, in the case of

Eldredge v. *U. S.*, 31 F. (2d) 924,

that an option on mining ground given before March 1, 1913, which had reached high value on the latter date and was certain to be exercised thereafter, would be treated as though it were exercised.

In the foregoing cases cited from the Third and Sixth Circuits, the optionee was in possession, and had developed and improved the land to a value at March 1, 1913, so far in excess of the option price that he was treated as the practical owner, the economic owner, of the land at March 1, 1913.

It seems to us that those cases are in line with recent enunciations by this Court of the doctrine of economic ownership, "economic interest," *e. g.*, as in

Palmer v. *Bender*, 287 U. S. 551, 558.

It is clear that on March 1, 1913, respondent was the economic owner of the land, then of a value of $1,635,000.00, with a purchase price of only $200,000.00. The value of the land was not available to the optionor, at March 1, 1913, because his legal title could not be then valued at more than $200,000.00, for the reason that his tile was *cum onere*, burdened by the $200,000.00 option, *Wilson* v. *Bowers*, 51 F. (2d) 261. Can it be that on March 1, 1913, *no one* owned property amounting to the difference between $200,000.00 and $1,635,000.00? Surely, from every viewpoint, respondent was the practical and economic owner of the property. We adopt the reasoning of the Circuit Court of Appeals upon the impossibility of reaching any different view, consistently with the Constitution (R. 341).

If the optionee had sold its option after March 1, 1913, but before exercise in 1916, it would have been entitled to use as a basis for determining the gain on such sale, the value of the option on March 1, 1913, and only the small difference would have been taxable, *i. e.*, the increase in value of the option after March 1, 1913. If the purchaser of the option had paid for it, for example, $1,400,000.00, and then had exercised the option, its basis for the properties would have been not only the $200,000.00 actually paid to the optionor, but also the $1,400,000.00 previously paid for the option, or a total of $1,600,000.00. This shows clearly that if the exercise of an option is not a realizing and taxable transaction the basis for the property acquired under the option is the sum total of the following: (a) The amount paid to the owner of the land at the time of the exercise of the option, to-wit, $200,000.00; and (b) the cost or other basis of the option itself. In the case of the purchaser, referred to above, such cost would be $1,400,000.00. In our

case it would be the cost or March 1, 1913 value, whichever was higher. Since the March 1, 1913, value of the option was approximately $1,360,000.00, that should be substituted as the basis for the option. What has the taxpayer done to forfeit that value as of March 1, 1913?

II.

If Respondent Did Not Acquire the Property Before March 1, 1913, Then There Was a Conversion of Capital Assets on November 30, 1916, and Respondent Would Be Entitled to the Value of the Land and Improvements at the Latter Date as a Basis for Determining Profit on Sales.

Because of the conclusion it reached that the property was acquired before March 1, 1913, the Circuit Court of Appeals said (R. 344):

> "The conclusion we have reached as to the effect of the exercise of the option also disposes of petitioner's contention that the transaction on November 30, 1916 resulted in an exchange of capital assets and renders further discussion of that contention unnecessary."

Consequently, our assignments of error 4 and 5 (R. 284), remain to be decided if this Court should rule that the property was not acquired before March 1, 1913. The assignments of error were fully argued in our brief in the Circuit Court of Appeals, at pages 23-27. In substance, the argument is that if the property was acquired *after* March 1, 1913, *i. e.*, when the option was exercised on November 30, 1916, then there was a *conversion of capital* on the latter date, *i. e.*, capital assets consisting of (1) an absolute vested property right, a highly valuable option, and (2) purchase money. The conversion was into the legal fee simple absolute of the 1000 acre grove, of the value of $2,150,000.00. Plainly, the new asset, the converted form, had "essentially different characteristics" (*Marr* v. *U. S.*, 268 U. S., 536,

540) than had the old assets, and there was a "conversion of capital."

It follows that there was a closed transaction, and therefore that the basis of the property for the subsequent years at bar (1920 and later years) is the value of the land and improvements on November 30, 1916.

Respectfully,

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